Singapore Management University
Institutional Knowledge at Singapore Management University

Perspectives@SMU | Centre for Management Practice

2-2019

Preventing accounting fraud

Singapore Management University

Preventing accounting fraud

28 Feb 2019

Technology can help identify possible fraud but it might not overcome 'capture theory'

The early 21st century was a bad time for corporate America. Enron, WorldCom and Tyco International – among others – dominated headlines for accounting frauds that ran into billions of dollars. In the case of Enron it led to the demise of its auditors Arthur Andersen, whittling down the Big Five of accounting firms to a Big Four. The 2002 Sarbanes-Oxley Act was introduced to prevent similar future wrongdoing, along with the creation of the Public Company Accounting Oversight Board (PCAOB) to protect the interests of investors.

Even so, Lehman Brothers' collapse in 2008 proved that "cooking the books" will always be a temptation for corporate bigwigs, especially when compensation is tied to a company's earnings or stock price. What can be done to better protect shareholders and investors?

"An important line of defence is fraud detection," states **Samuel Tan**, Assistant Professor of Accounting at the SMU School of Accountancy. Accounting researchers use data analytics to identify likely cases of financial misconduct, and are constantly developing new techniques for fraud detection.

For example, researchers have found that by looking at the Management Discussion and Analysis (MD&A) portion of a company's annual report, it is possible to perform what is called "textual analysis" to detect possible irregularities.

Textual analysis can also be applied to the spoken word.

"Managers explain their financial results to shareholders in earnings calls," Tan tells Perspectives@SMU, "and the papers explored the possibility of identifying misreporting by the firm based on linguistic analysis of the conference calls. That's another way of applying textual analysis."

Regulating

Tan elaborates that textual analysis is "writ[ing] programs to parse out text" to detect possible areas of concern – something that would be useful for auditors. It is also useful, Tan adds, for regulators.

"What has been happening in financial accounting research worldwide is a shift towards more sophisticated tools to better understand the business world," he says. "We need regulators that understand the tools that can be used to identify fraud, in order to correct it.

"Training matters a lot. Training and tools can help people at the policymaking level and auditor level to find transactions where they should question management about anything dubious."

But even if the regulator is highly trained and applies the law down to the letter, human relations can get in the way of effective regulation. In his working paper "Individual Lawyers, the SEC Revolving Door, and Comment Letters", Tan finds that hiring a lawyer who was formerly employed by a government regulator may help companies get more favourable outcomes from the regulator.

Is that not just the smart thing to do?

"It would be bad for investors if former government regulators are joining companies with the knowledge of how to find loopholes and allowing these companies to find the loopholes," Tan posits, pointing out what is called the "capture theory of regulation".

He continues: "Another possible theory is what is known as the human capital theory, which is that companies hire regulators who are more aggressive at enforcing regulation. When these regulators leave the government, they may help companies better comply with the law.

"My research has tended to agree with the argument that it hurts investors. Part of our findings suggest that a company that hires a lawyer who was employed by a regulator is less likely to make changes requested by the regulator. Specifically, a company is less likely to change its financial reports after receiving comments from a regulator, if it hires a lawyer who used to work for the regulator." He notes:

> *"In this dialogue between companies and regulators, the human element plays a big role. There's an interesting example where the U.S. government was questioning a company regarding its accounting for a special purpose vehicle. There were multiple rounds of dialogue between the government and the firm, but the issue was resolved after a phone call with the regulator's staff. The inquiry was dropped after the call, and it was agreed that all the company had to do was to reclassify several items in future filings."*

"Companies," he concludes, "can try to persuade staff at regulators, and if the company's lawyer is talking to former colleagues at the regulators, the company may appear more convincing. The human element plays a big role."

Follow us on Twitter (@sgsmuperspectiv) or like us on Facebook (https://www.facebook.com/PerspectivesAtSMU)